



Papua New Guinea

While economic growth has picked up, it is likely to slow. The terms of trade have deteriorated, the exchange rate is likely to come under pressure in 1998, and the banking system is suffering from a major liquidity overhang. In addition, measures taken to ameliorate the recent drought were inadequate.

RECENT TRENDS AND PROSPECTS

Economic growth recovered in 1996 but sharply declined to -6.5 percent in 1997. Completion of the Lihir mine, pre-election expenditures, and rising incomes from agricultural crops all contributed to GDP growth. However, a major drought, and a fall in gold and copper prices affected growth during the second half of 1997. In addition, Papua New Guinea (PNG) was affected by another bout of political instability. Rain recently provided some relief in certain areas of the country, although the current coffee and cocoa outputs are still expected to be some 20 percent less than in 1997. Therefore, GDP growth is likely to decelerate in the future.

The rate of inflation fell to 3.9 percent in 1997. After a period of relative stability, further weakening of the currency was evident in late 1997 despite a buildup of substantial foreign exchange reserves, which amounted to some K768 million (\$1,061 million) by mid-1997, or 5.8 months of import cover. The weakness in the currency reflects the following: a recent decline in the terms of trade, the significant food imports as a result of the drought, the prospective decline in volumes of agricultural and mining exports, and the reduced confidence in the economy and in government policies. The terms of trade declined by 10 percent in 1997 because of declining copper, gold, and timber prices.

The banking sector poses an additional problem. Demand deposits in banks have grown rapidly in recent years. As these deposits can be converted on demand to foreign exchange in PNG, the existing level of reserves, while not low, is not necessarily comfortable. To ward off any possibility of mass conversion of demand deposits into foreign currency, the authorities have reacted by allowing the currency to weaken rather than face eventual pressure on reserves.

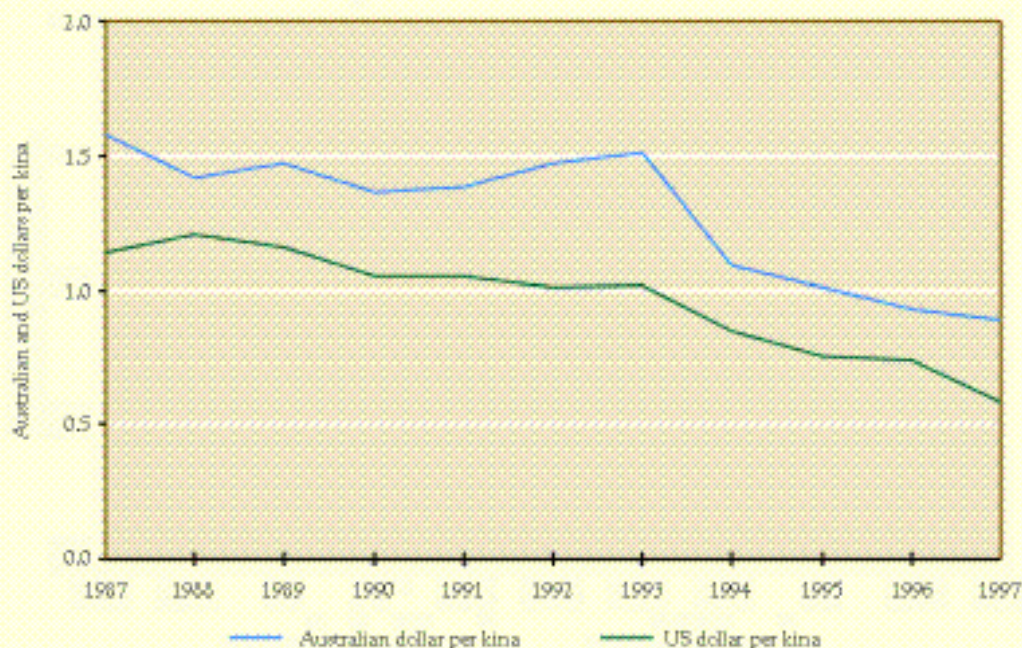
Interest rates have been pushed up in response to possible pressure on foreign exchange reserves. The Treasury bill rate increased from 9 percent in September 1997 to 13 percent by early December. A small budget deficit was recorded in 1997.

The mining sector's contribution to economic activity and export revenue is likely to fall sharply in 1998. Both major mines have become victims of the drought because of the lack of water for processing. One of them completely stopped shipments in August 1997, while the other operated at 12 percent of capacity. Tax revenues generated from the mining sector are also expected to be considerably lower in 1998 than in 1997.

CRITICAL ISSUES IN SHORT-TERM ECONOMIC MANAGEMENT

Managing a buildup of liquidity in the banking system, maintaining a prudent approach to fiscal

Figure 2.14 Australian Dollar and US Dollar per Kina Exchange Rates:
Papua New Guinea, 1987-1997



Source: Bank of Papua New Guinea data.

policy, managing the exchange rate, and responding effectively to the drought are the key short-term issues. The monetary system accumulated excessive liquidity during the period of fiscal expansion in 1993 and 1994. By late 1997 the government was running a small surplus.

Although recent rains have provided some respite, many communities still face a desperate situation because of record drought. Food shortages are likely to occur in 1998, and estimates indicate that up to 650,000 people will need food aid for several months in early 1998, and a monthly cost of K6 million (\$8.29 million).

POLICY AND DEVELOPMENT ISSUES

The economy is beset with long-standing structural problems. The key constraints are a serious and widespread law and order problem, formal and informal institutions that are ineffective in facilitating economic development, poor workforce skills, and inadequate infrastructure. Together these constraints lead to an environment that is not conducive to broadly based economic growth. The structural

adjustment program that is currently being implemented contains a range of measures to liberalize the economy through trade and tax reforms, improve the management of forestry resources, restore fiscal stability, increase public investment, and improve social services. While the government has been able to deliver on some key macroeconomic targets that were part of the structural adjustment program, little fundamental reform has taken place. No progress has been made in improving the government's efficiency and effectiveness, and the privatization program has stalled.

A supply bill was introduced in November 1997, and the government announced a delay in the implementation of the value-added tax to 1999. The delay is a problem, because tariffs have already been reduced, and this has left the government with a revenue shortage. The supply bill increased the top income tax rate to 47 percent and created three new tax brackets. On the one hand, this is not likely to raise much revenue, and on the other, it is likely to discourage foreign investors.

Public governance suffers from major weaknesses and the entire government system exhibits a

pervasive lack of accountability for performance. A major long-standing issue is that government policy generally tends to be ad hoc and highly politicized. Effective medium-term fiscal planning and fiscal responsibility legislation are lacking, policy reversals are common, and large gaps between announced policies and actual implementation are frequent.

Under the new constitutional law, government decentralization is to be promoted and the importance of provincial and local governments is to be enhanced. To this end, a large array of programs and services are being developed that provincial and local governments are to implement. The budget has earmarked funds to meet the financial requirements of the provincial and local governments. However, fund transfers have not taken place to

date, creating tension between the provincial and local governments and the central government. The new division of responsibilities is not absolutely clear-cut, and a good deal of confusion exists about the revised roles of central government departments and provincial and local government departments. To further complicate the situation, under the new scheme most central government departments were to be restructured, but progress with the restructuring has been limited. The provincial governments have their own restructuring-related problems in that they are short of administrative and technical manpower. Given these problems, doubts have been raised about whether the reforms will work. Critics increasingly believe that the intended improvement in governance will be difficult to accomplish.